Weekly commentary

BlackRock

June 22, 2020

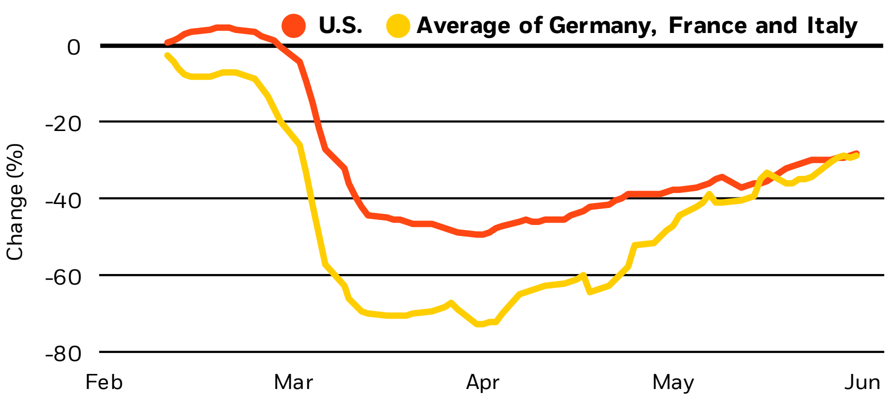
Warming up to Europe

- We are warming up to European assets as the region steps up its policy response and demonstrates relative success in tamping virus growth.
- We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen.
- A spate of business and consumer sentiment data this week should shed light on the pace of the activity rebound as economies reopen.

Europe's policy response to the virus shock was slow to get going – but an impressive array of fiscal and monetary measures is getting into place to bridge the economy through the shock. The euro area has also had relative success in tamping virus growth, positioning it well for reopening its economy. We see the two factors as supporting the region's economy and markets in coming months.

Chart of the week

Google mobility data for U.S and key euro area economies, 2020



Sources: BlackRock Investment Institute, with data from Google, June 2020. Notes: The chart shows the percentage change in mobility (seven-day moving average) relative to the median level between Jan. 3 and Feb. 6, 2020. The yellow line is a simple average of Germany, France and Italy. The lines start on Feb. 24.

Lockdowns in Europe started relatively early and caused mobility to plummet. Google data – which use mobile phone location data to measure the change in visits to stores and workplaces as well as use of public transit – show average mobility levels across Germany, France and Italy plunging more than 70% below pre-virus levels. See the yellow line in the chart. The sharp drop was a huge drag for activity in the short term, but helped curb the virus spread more effectively. Mobility has rebounded quickly and is now on par with the level in the U.S. This bodes well for a pickup in activity, especially as it comes with a lower risk of infection resurgence, in our view. As a result, we could see the pace of recovery in the second half outpacing other regions, including the U.S.

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After an initially slow start, the euro area's policy response to the virus shock is picking up pace, with additional spending measures announced recently by Germany and France. Combined with additional monetary support, the size of stimulus is broadly sufficient to match the income shortfall on a euro area level, our analysis shows. The European Central Bank (ECB) has launched new and more flexible quantitative easing: the pandemic emergency purchase program (PEPP). Its targeted longer-term refinancing operations (TLTRO) scheme holds the promise to provide support to the private sector via cheap loans to banks. The ECB has also made clear that it stands ready to do more in monetary policy stimulus if the inflation outlook is still not showing sufficient progress toward price stability in September.

In addition, we see the new 750-billion-euro European recovery plan as a crucial turning point for Europe's economy and financial markets. The bulk of the proceeds will be distributed as grants – over and above offering cheap financing to ensure the flow of credit to virus-hit economies through new European Stability Mechanism (ESM) credit lines. It will also for the first time create a jointly issued European "safe" asset of a meaningful size. Such pan-European debt would start to rival the total volume of German federal government debt outstanding, after including the almost 300 billion euros of ESM debt outstanding. To be sure, this is not a "Hamiltonian moment" for Europe - harkening back to the U.S. federal government assuming the debts that states incurred in the War of Independence. It's about newly issued debt, and more work is needed to move the euro area toward a fully-fledged fiscal union.

Policy implementation risks remain. And the risk of a no-deal Brexit looms. Yet our BlackRock geopolitical risk indicator already shows elevated market attention to the European fragmentation risk, suggesting markets may have priced in at least part of that risk.

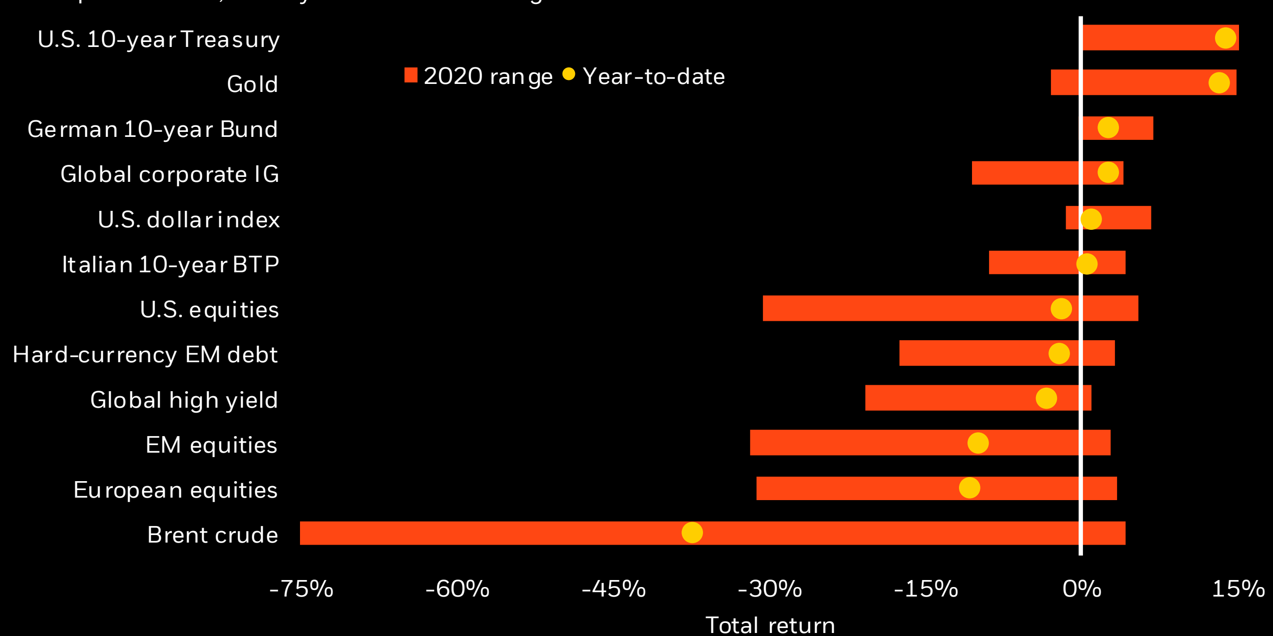
Bottom line: We are seeing many reasons to be optimistic about the euro area in the second half of 2020, including the ramped-up policy response and effective public health measures. The sum total of the euro area's policy actions looks impressive – and they come on top of relatively large automatic stabilizers such as generous welfare benefits. As a result we maintain our overweight in European peripheral government bonds and are considering an upgrade to European equities.

Market backdrop

Measures to contain the virus are gradually being eased in many developed economies. May's data suggested the worst of the contraction may be behind us, but we see a bumpy restart in coming months. We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen. The unprecedented policy response has boosted markets, leaving a potential resurgence of infections and policy implementation as key risks. U.S. Congress is headed for a fiscal cliff as jobless benefits, state support and payroll protection measures are expiring soon.

Assets in review

Selected asset performance, 2020 year-to-date and range



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, June 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, and the dots represent year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

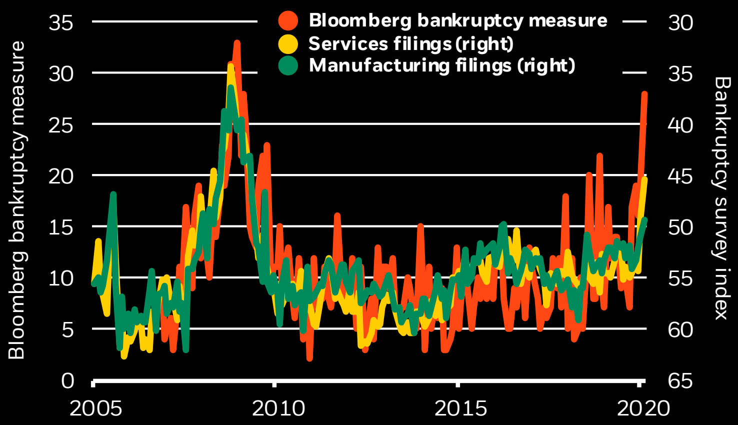
Macro insights

One of the signposts we are using to track the coronavirus shock is emerging signs of financial vulnerabilities. We judged these to be limited before the pandemic, and we still see only a modest chance of the shock turning into systemic financial stress and permanent scarring of capacity. This means the permanent income loss is likely to be just a fraction of that caused by the global financial crisis.

We do see a rise in financial vulnerabilities over the medium term due to higher unemployment and default rates, and significantly greater debt levels resulting from the disruptions to incomes and cashflows. Both households and businesses continue to benefit from fiscal and monetary policy. But policy fatigue remains a risk, especially in the U.S. Existing financial vulnerabilities – such as corporate debt levels – could be amplified by the crisis. There are signs of an uptick in bankruptcies in the U.S., with the service sector taking a heavier hit than manufacturing. See the chart to the right.

Bankruptcy rises

U.S. bankruptcy indicators, 2005-2020



Sources: BlackRock Investment Institute, National Association of Credit Management (NACM) and Bloomberg, with data from Haver Analytics, June 2020. Notes: The NACM indexes show filings for bankruptcies in the service and manufacturing sectors as measured by the NACM survey. A lower number means filings for bankruptcies increased (note the right-hand scale is inverted). The Bloomberg bankruptcy measure is a monthly total of U.S. corporate bankruptcy filings reported by Bloomberg.

Investment themes

1 Activity standstill

- The coronavirus shock is unprecedented and sharper than what we saw in 2008 – but its cumulative hit to growth is likely to be lower as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock. The main risk to our view: The decisive policy response is not delivered in a successful and timely fashion, causing lasting damage to the economy.
- The rate of growth in virus cases looks to be slowing in many regions, and stringent shutdown measures are gradually being lifted.
- The nature of the activity rebound will depend on the path of the outbreak, delivery of policy response and potential changes to consumer and corporate behaviors. Success will not just be about restarting the economy and containing the virus – but balancing both objectives.
- **Market implication**: We are sticking to benchmark holdings in most asset classes and prefer credit over equities.

2 Bold policy action

- A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets has taken shape, particularly in the U.S. The U.S. unemployment rate remains elevated, underscoring the need for effective policy implementation. The risk now is policy exhaustion, especially as U.S. fiscal measures are set to expire soon.
- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the shock and ensuring markets function properly. We could see its balance sheet more than double to just over $10 trillion by year end to support the fiscal response. The U.S. Treasury smashed records by setting out a $3 trillion borrowing plan in its quarterly refunding to fund the response – showing the blurring of lines between monetary and fiscal policy.
- The Fed has so far steered clear of committing to explicit yield curve control.
- We are gaining confidence in Europe's policy response. The European Central Bank's latest targeted long-term refinancing operation (TLTRO-III) was met with a record €1.3 trillion of demand. The Bank of England boosted its monetary easing by £100 billion, although weekly asset purchases may slow.
- A German constitutional court ruling threatens the ECB's independence and could lead to euro area fragmentation in the long run. It's crucial to have proper guard rails around policy coordination, as we discuss in Policy Revolution.
- China moved away from setting a GDP growth target for 2020, emphasizing quality of growth over quantity, and announced fiscal stimulus of at least 4% of GDP.
- Central banks have moved from alleviating dysfunctional market pricing and tightening financial conditions to ensuring credit flows to businesses and local governments.
- We see risks of implementation and policy exhaustion. Next rounds of U.S. fiscal stimulus look harder to achieve because of a return of political polarization after a short window of bipartisanship.
- **Market implication**: Coupon income is crucial in an even more yield-starved world, including corporate credit.

3 Resilience rules

- Portfolio resilience has to go beyond nominal government bonds and consider alternative return sources that can provide diversification, such as private markets.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a tectonic shift that will carry a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for sustainable investing and private markets.

Week ahead

June 22 Euro area consumer confidence flash

June 23 U.S., UK and euro area flash PMIs

June 24 German IFO business survey

A spate of business and consumer sentiment data across the U.S. and Europe could help markets assess signs of a rebound in activity. The pace of the activity restart depends on how successful countries are in suppressing the virus. We see a greater danger of renewed outbreaks in the U.S., UK and Canada than in Germany and Japan, based on our research on the relationship between mobility and virus infection rates.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, June 2020

Asset	Underweight / Neutral / Overweight
Equities	We are neutral on global equities. Global economic activity has been almost halted in order to stem the spread of the coronavirus. Overwhelming and aggressive policy action – both fiscal and monetary – help support the asset class. We prefer an up-in-quality stance, and like economies with ample policy room.
Credit	We have upgraded credit to modestly overweight. Extraordinary measures by central banks – including purchases of corporate debt – provide a favorable backdrop. Developed market central bank actions should pave the way for lower volatility in interest rates, providing a stable environment for credit spreads to narrow. The risk of temporary liquidity crunches remains. Yet valuations have cheapened and coupon income is crucial in a world starved for yield.
Government bonds	We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market selloffs and a snap-back in yields from historically low levels.
Cash	We maintain our neutral position on cash for risk mitigation. We also see cash as a robust buffer against risks around regime shifts, especially those triggered by a negative supply shock that could drive both stocks and bonds lower together.

Note: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

Granular views

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, June 2020

	Asset	Underweight	Overweight	
Equities	United States		■	We are overweight U.S. equities for their relative quality bias and the sizable policy response to the outbreak: large fiscal stimulus coupled with the Federal Reserve's commitment to keep rates low and markets functioning.
	Euro area	■		We are reviewing our stance on European equities as we see them as a way to gain cyclical exposure. The ramped-up policy response and solid public health measures provide a positive background for an activity pickup.
	Japan	■		We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
	Emerging markets			We are neutral on EM equities. Valuations have cheapened, but the global economic slowdown and cheaper oil challenge many EM economies. The outbreak also is a big test for weak public health systems.
	Asia ex-Japan		■	We are overweight Asia ex-Japan equities on prospects of an eventual growth uptick. We see China as in the early stages of restarting its economy and having more policy space to revive activity.
	Momentum			We are neutral on momentum. The factor has outperformed in the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend paying bond proxies.
	Value	■		We remain underweight value. Value has historically performed best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
	Minimum volatility		■	We like min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
	Quality		■	We hold quality as an overweight. We like that it has been resilient in late-cycle periods, despite relatively high valuations.
Fixed Income	U.S. Treasuries		■	We like U.S. Treasuries. Low rates reduce their ability to cushion against risk asset selloffs, but we see greater room for long-term yields to fall further in the U.S. than in other developed markets.
	Treasury Inflation-Protected Securities			We are neutral on TIPS. A huge decline in rates has made the entry point less attractive, yet we still see potential for higher inflation over time and like TIPS in strategic allocations.
	German bunds	■		We remain underweight bunds. They provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
	Euro area peripherals		■	We are holding our overweight in euro area peripheral government bonds. Fiscal authorities increased stimulus and the European Central Bank expanded its asset purchases program to cushion the pandemic's impact.
	Global investment grade		■	We like global investment grade credit. Renewed asset purchases by central banks as well as the prospect of a stable rates backdrop support the sector at a time when valuations have cheapened.
	Global high yield		■	We stay overweight high yield as a source of income, despite recent underperformance. We avoid energy as a lower-for-longer oil price challenges the ability of issuers to refinance near-term maturities.
	Emerging market – hard currency			We stay neutral on hard-currency EM debt due to the heavy exposure to energy exporters and limited policy space among some markets. Default risks may be underpriced.
	Emerging market – local currency			We are neutral on local-currency EM debt to neutral because we see a risk of further currency declines in key markets amid monetary and fiscal easing. This could wipe out the asset class's attractive coupon income.
	Asia fixed income		■	We stay overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We see demand from Chinese and regional investors.

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